

CALIFORNIA STATE TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Equity- Soft Dollar Discussion

ITEM NUMBER: 8

ATTACHMENT(S): 1

ACTION: _____

DATE OF MEETING: March 3, 1999

INFORMATION: X

PRESENTER(S): PCA- Mr. Emkin
Ms. Okada

Executive Summary

One of the Investment Branch objectives for 1998/99 was to review and revise the policies and procedures for the soft dollar program. This area has been one of ongoing scrutiny by the Securities and Exchange Commission (SEC) and the plan sponsor community. The materials provide a definition for directed brokerage, a brief history of the major developments in this area, Section 28(e) Safe Harbor, and peer concepts and approaches. For the purposes of this analysis, directed brokerage has been divided into investment adviser directed and, plan sponsor directed programs. In this report, the terms directed brokerage and soft dollar are considered synonymous have been used interchangeably.

In all directed brokerage arrangements, the investment adviser must always act for the *EXCLUSIVE* benefit of its clients and place the clients' interest before its own.

The primary purpose of directed brokerage is to directly or indirectly compensate the brokerage industry for providing research. Providing research is one important, long-standing service of Wall Street brokerage businesses. Directed brokerage arrangements have developed as a link between the brokerage industry's supply of research and the money management and plan sponsor demand for research.

A secondary purpose is to directly compensate a third party for research products or services received by the plan sponsor. Because the commission dollars are an asset of the plan sponsor, the practice of client directed brokerage does not per se violate any investment adviser duties.

This report has been provided for education and discussion purposes. Next month a directed brokerage (soft dollar) policy will be presented to the Investment Committee for review and approval.

DIRECTED BROKERAGE

Definition

The Securities and Exchange Commission (SEC) has defined directed brokerage (soft dollar) practices as arrangements under which products or services, other than execution of securities transactions, are obtained by an investment adviser through a broker-dealer in exchange for the direction of client brokerage transactions to that broker-dealer.

Investment adviser directed transactions begin when the adviser selects the broker that will execute trades in addition to providing research and other services to the adviser. In exchange for research that directly assists the adviser in their investment decision making process, the adviser directs trades (commissions) to be executed through a specific broker for payment. In soft dollar arrangements, the investment adviser must exclusively act for the benefit of its clients. Soft dollar arrangements have the potential for conflict of interest situations. Specific discussion is provided below on appropriate arrangements and Section 28(e) Safe Harbor provisions.

Plan sponsor directed transactions begin when a client asks its investment adviser, subject to the adviser's satisfaction that the client is receiving best execution, to direct trades (commissions) to a particular broker that has agreed to provide services, pay obligations, or make cash rebates to the plan sponsor. Client direction does not involve the same conflicts posed by adviser direction and does not implicate the provisions of the safe harbor. Conflict concerns are not raised by client direction arrangements because these transactions involve use of plan sponsor's commission dollars to obtain products or services that directly and exclusively benefit the fund. In a client directed brokerage arrangement, the broker has agreed to charge a specified commission with a predetermined portion being used to pay qualifying plan sponsor obligations or to rebate part of that commission to the plan sponsor directly.

Background

Prior to May 1975, domestic equity commission rates were fixed at artificially high levels that far exceeded the cost of completing trades. Investment advisers took advantage of competition among brokers, and their willingness to accept compensation lower than the fixed rates, by recapturing a portion of the commissions paid on institutional orders. This situation supported an increasingly complex pattern of soft dollar arrangements to recapture a portion of the commissions, including "give-ups" and other "reciprocal practices" as a reward for research ideas furnished by brokers.

The Securities and Exchange Commission abolished the system of fixed commissions and implemented the present system of negotiated rates, effective May 1, 1975. Soon thereafter, the U.S. Congress enacted Section 28(e) as part of the Securities Acts Amendments of 1975. The U.S. Congress acted in response to concerns expressed by investment advisers and brokers that, under the new system of negotiated rates, if advisers caused a client account to pay anything but the lowest commission rate available to obtain research ("paying up"), they would be held in breach of their fiduciary duty to their clients. Section 28(e) provides that an adviser who exercises investment discretion with respect to an account shall not be deemed to have acted unlawfully or to have breached a fiduciary duty solely by reason of his having caused the account to pay more than the lowest available commission if such person determines, in good faith, that the amount of the commission is reasonable in relation to the value of the product and services provided. Congress determined that the investment advisers must use business judgment in selecting brokers and negotiating commissions.

Because Section 28(e) is a safe harbor, it cannot be violated. An investment adviser that proposes to use client commissions outside of the safe harbor would need to carefully consider its obligations pursuant to its fiduciary duties to its clients. An adviser is obligated under both the Investment Advisers Act of 1940 and state law to act in the best interests of its client. It also should be noted that Section 28(e) only excuses paying more than the lowest available commission. It does not shield a person who exercises investment discretion from charges of violations of the antifraud provisions of the federal securities laws arising from churning an account, failing to obtain the best price or best execution, or failing to make required disclosure.

September 1998 SEC Report

In the normal course of business, broker-dealers typically provide a bundle of services including investment research and trade execution. The research provided can be either proprietary (created and provided by the broker-dealer, including access to economists, analysts, or traders) or third-party (created by a third-party but provided by the broker-dealer). Because commission dollars pay for the entire bundle of services, the practice of allocating certain of these dollars to pay for the research component has been called "soft dollars".

Under traditional fiduciary principles, a fiduciary must always act for the benefit of its clients and place the client's interest before its own. When an adviser uses client commissions to purchase research or other products from a broker-dealer, the adviser receives a benefit because it is relieved from the need to pay using hard dollars (cash). If a transaction involving soft dollars requires the adviser to pay higher commissions or receive trade executions at inferior prices, those advisers face a potential conflict of interest between their need to obtain research and their clients' interest in best execution (paying the lowest commission rate available and obtaining the best possible pricing). Advisers

and broker-dealers are not obligated to obtain the lowest possible commission cost, but rather should seek to obtain the most favorable terms for a customer transaction reasonably available under the circumstances.

Soon after "May Day" 1975, when the SEC abolished fixed commission rates, the U.S. Congress created a safe harbor under Section 28(e) of the Securities Exchange Act of 1934 ("Exchange Act") to protect advisers from claims that they had breached their fiduciary duties by causing clients to pay more than the lowest available commission rates in exchange for research, products or services. Since 1975, the use of soft dollars has grown, as have the number of firms that provide research and other products and services in exchange for soft dollar payment. The total value of products and services purchased annually with soft dollars is estimated to exceed \$1 billion. There have been diverse perceptions by observers that the use of soft dollars is either inherently abusive or beneficial to clients (or somewhere in-between).

The SEC conducted limited scope inspection of the soft dollar activities of 75 broker-dealers and 280 investment advisers and investment companies from November 1996 through April 1997. In the aggregate, these advisers managed over \$2.6 trillion in 450,000 private accounts. This review covered \$274 million in soft dollar payments for third-party products and services. The SEC found that almost all advisers obtain some products and services (both proprietary and third-party) in addition to pure execution from broker-dealers and use client commissions to pay for those products and services. The broker-dealers, investment advisers, and investment companies participating in soft dollar arrangements were of all types and sizes. Most products and services obtained by advisers with soft dollars fall within the definition of research (lawful and appropriate assistance to the adviser in the performance of its investment decision-making responsibilities). Thus, the vast majority of products and services received by advisers were within the safe harbor established by Section 28(e) of the Exchange Act.

The SEC found that the average commission rate on third-party soft dollar trades was six cents per share, the same average rate being paid to firms providing proprietary research. This suggests that, while there is no separately itemized charge for proprietary soft dollar benefits, advisers have placed an equivalent value on these services. The SEC found it difficult to separate a specific amount for products and services and a specific amount reflecting the payment for the care used in obtaining best execution for these transactions.

Pros and Cons of Soft Dollar Arrangements

The supporters of soft dollar arrangements offer a variety of arguments in support of investment advisers being allowed to use commission dollars to obtain research and services from broker-dealers, including the following: **“Soft Dollar Arrangements Encourage More and Better Quality Research and Result in Better Decision Making”**.

An argument in favor of soft dollar usage is that it gives investment advisers the ability to obtain additional research services that should result in the most effective management of client accounts. Under this argument, the ability of broker-dealers to provide research services in return for brokerage commissions encourages more - and better - research because more institutions produce it, and clients benefit when advisers have the broadest possible access to research, since it helps them arrive at the most informed decisions in managing client assets.

Both the SEC and Congress have acknowledged the positive effects of research on investment decision making. The basic value of securities research is that it provides advisers and other investors with a continuous flow of information and opinions on securities, thereby in theory leading to confidence and better judgments by investors. Securities research also helps to allocate investment capital to deserving companies and to encourage better corporate disclosure. At the same time, by exposing overvalued companies, securities research can prevent artificially inflated securities prices, as well as pressure management of underperforming companies to make necessary strategic or tactical changes.

The argument that soft dollars can lead to better investment decision making seems particularly relevant to smaller investment advisers, who because of their size may not have an extensive in-house research effort. For these advisers, access to external research sources through soft dollar arrangements provides a cost-effective way for them to obtain access to more sophisticated and specialized research.

The detractors of soft dollar arrangements offer a variety of arguments against advisers being allowed to use commission dollars to obtain research and services from broker-dealers, including the following: (1) **Soft Dollar Arrangements Involve an Inherent Conflict of Interest and a Potential Violation of Fiduciary Duty**, (2) **Soft Dollar Arrangements May Lead to Excessive Trading**, and (3) **Soft Dollars Arrangements May Raise a Conflict of Interest for Consultants**.

Fiduciaries have a duty to act only in the interest of clients and not to derive economic benefit from transactions at their expense. Under a typical soft dollar arrangement, an adviser is not forced to pay hard dollars to obtain research and other services from a broker-dealer. Rather, all of the broker-dealer's compensation (i.e., both for execution and research) is paid from client accounts. This saves the adviser research expenses it would otherwise be forced to bear.

It is argued that, as part of providing money management services, an adviser should be expected to obtain any necessary research at its own expense. Under this argument, soft dollar arrangements permit the adviser to use client assets to reduce its own expenses, resulting in a conflict of interest and possible unjust enrichment to the adviser.

Some argue that, to the extent a adviser has made implicit commitments to a broker-dealer to provide a certain level of commissions in return for research services, or simply wants to accrue soft dollar credits or obtain additional research, the adviser may have an incentive to overtrade - i.e., "churn" - clients' accounts simply to generate more commissions. Third-party research in particular, it is argued, may involve an inherent conflict of interest if a adviser commits a substantial percentage of its commissions to pay for research, since this could adversely affect the quality of executions or lead a adviser to trade excessively to meet its commitments.

Many pension plan administrators and other large accounts retain consultants to aid them in selecting and monitoring investment advisers, and in many cases these consultants will also be vendors of research services in return for soft dollars. Detractors believe that there is at least a perception among some advisers that they cannot get into many plan sponsors' searches unless recommended by a consultant, and the best way to obtain such a recommendation is to subscribe to one or more of the consultant's research services. While not all consultants offer these research services, concerns have been raised about whether there are adequate "Chinese Walls" between these two lines of business by consultants to ensure the absence of a conflict of interest.

DEFINITIONS

“Agency Trade” a trade in which the broker acts as agent and executes buy or sell for a customer. A commission is charged for the service.

“Agent” the role of a broker/dealer firm when it acts as an intermediary between its customer and another customer. For this service the broker receives a commission.

“Best Execution” refers to executing Client transactions so that the Client's *total cost* is the most favorable under the particular circumstances at that time.

“Broker” refers to a person or entity registered with the National Association of Security Dealers and provides investment services (research, soft dollars, etc) and/or execution services.

“Brokerage” refers to the amount on any trade retained by a Broker to be used directly or indirectly as payment for execution services and, when applicable, research supplied to the Investment Adviser or its Client in connection with Soft Dollar Arrangements or for benefits provided to the Client in Client-Directed Brokerage Arrangements. For these purposes, trades may be conducted on an agency or principal basis.

“Brokerage Arrangement” refers to an arrangement whereby a Broker provides services or products in addition to execution. Brokerage Arrangements include Investment Adviser-Directed and Client Directed Brokerage Arrangements.

“Brokerage and Research Services” refers to services and/or products provided by a Broker to an Investment Adviser through a Brokerage Arrangement, including trade execution; the furnishing of relevant advice relating to the purchasing and selling of securities; analysis and reports relating to relevant market information; and the performance of incidental functions, such as clearance, settlement and custody.

“Client” refers to the entity, including a natural person, investment fund or separate account designated to receive the benefits, including income, from the Brokerage generated through Securities Transactions. A Client may be represented by a trustee or other Fiduciary, who may or may not have Investment Discretion.

“Client-Directed Brokerage Arrangement” refers to arrangement whereby a Client directs that trades, for its account, be executed through a specific Broker in exchange for which the Client receives a benefit in addition to execution services. Client-Directed Brokerage Arrangements include rebates, commission banking and commission recapture programs through which the Broker provides the Client with cash or services or pays certain

obligations of the Client. A Client may also direct the use of limited lists of broker-not for the purpose of reducing Brokerage costs, but to effect various other goals (e.g., increased diversity by using minority-owned brokers) or geographical concentration.

“Commission” refers to the amount paid to the Broker in addition to the price of the security and applicable regulatory fees, on an agency trade.

“Fiduciary” refers to any entity, or a natural person, including an AIMR Member, that has discretionary authority or responsibility for the management of a Client’s assets or other relationships of special trust.

“Hard Dollar” a term that refers to cash.

“Investment Decision-Making Process” refers to the quantitative and qualitative processes and related tools used by the Investment Adviser in rendering investment advice to its Clients, including financial analysis, trading and risk analysis, securities selection, broker selection, asset allocation and suitability analysis.

“Investment Discretion” refers to the sole or shared authority (whether or not exercised) to determine what securities or other assets to purchase or sell on behalf of a Client.

“Investment Adviser” refers to any entity, or a natural person, including an AIMR Member, that serves in the capacity of asset adviser to a Client. The Investment Adviser may have sole, shared, or no investment Discretion over an account.

“Mixed-Use” refers to services and/or products, provided to an Investment Adviser by a Broker through a Brokerage Arrangement that have the capacity to be used for both the Investment Decision-Making Process and management of the investment firm.

“Principal Trade” a trade in which the broker acts on his own behalf and buys or sells for a customer.

“Proprietary Research Arrangement” refers to an arrangement whereby the Investment Adviser directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Adviser receives Research from, and/or access to, the “in-house” staff of the brokerage firms.

“Provided by a Broker” refers to (i) in Proprietary Research Arrangements, Research developed by the Broker and (ii) in Third-Party Research Arrangements, Research for which the obligation to pay is between the Broker and Third-Party Research Provider, not between the Investment Adviser and Third-party Research Provider.

“Ratio” represents the number of commission dollars to cash (hard dollars) required to purchase services. Examples: if a service cost \$100 in cash, at a ratio of 1.8:1, the commission (soft dollar) cost would be \$180 or $1.8 \times 100 = \$180$.

“Research” refers to services and/or products provided by a Broker, the primary content of which must, if used by the Investment Adviser, directly assist the Investment Adviser in its Investment Decision-Making Process and not in the management of the investment firm.

“Section 28(e) Safe Harbor” refers to the "safe harbor" set forth in Section 28(c) of the U.S. Securities Exchange Act of 1934, which provides that an Investment Adviser that has Investment Discretion over a Client account is not in breach of its fiduciary duty when paying more than the lowest Commission rate available if it determines in good faith that the rate paid is commensurate with the value of Brokerage and Research Services provided by the Broker.

“Securities Transactions” refers to any transactions involving a Broker, whether conducted on an agency basis or principal basis.

“Soft Dollar Arrangement” refers to an arrangement whereby the Investment Adviser directs transactions to a Broker, in exchange for which the Broker provides Brokerage and Research Services to the Investment Adviser. Soft Dollar Arrangements include Proprietary and Third-Party Research Arrangements but do *not* include Client-Directed Brokerage Arrangements. Soft Dollar Arrangements are sometimes referred to herein as Investment Adviser-Directed Brokerage Arrangements.

“Third-Party Research Arrangement” refers to an arrangement whereby the Investment Adviser directs a Broker to effect Securities Transactions for Client accounts in exchange for which the Investment Adviser receives Research provided by the Broker, which has been generated by an entity *other than* the executing Broker.